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5 Insights From Behavioral Economics That Can Help Startups Succeed

Anyone who's been involved in a startup knows that there's little room for error. One wrong move could be the difference between success and failure. So how can you increase the likelihood that your new business will not just survive, but thrive? This is where the science of behavioral economics – the merging of economic theory and social science – can help. It provides those operating startups, or any business for that matter, with the insights they need to make better decisions, which will improve their company's position in the marketplace. Here are five principles from behavioral economics that will increase the likelihood that a startup will succeed.

1. Focus On Losses, Not Gains

Behavioral economists assert that one of the most potent motivators of human behavior is fear of loss. In fact, researchers have shown that people are far more motivated to not lose something than to gain something of equal value at a ratio of 2:1.

So how can you leverage fear of loss? First, when you have a goal that you need to meet, put something (money, reputation, etc…) at risk. For instance, if you don't finish a project by the end of the month you will give $100 to a friend. Then give that friend the $100 and instruct him or her to only give it back to you if you accomplish your goal.

A second way you can utilize loss aversion in your favor is to clearly communicate to your potential customers they will lose if they don't invest in your product or service. Too often, presentations only focus on gains. Although sharing the beneficial outcomes your product or service will deliver is important, there is a mountain of research that confirms that others will be more motivated by what they will lose if they do not move forward.

2. Avoid The Sunk Cost Fallacy

Imagine the following scenario: You've poured a lot of time and resources into a new initiative, but the data suggests that it's not working and you should change course. Even though you know that you should abandon the project, you don't want to. You've already invested so much into it, your natural tendency is to just take the risk and see if you can turn it around. Yet, this could have catastrophic consequences for your business, so what should you do?

To determine the right course of action, it is imperative that you first recognize what is going on. The situation I just described illustrates a powerful bias known as sunk cost fallacy. What is sunk cost fallacy? It's the tendency to continue an endeavor because of previously invested resources. So, it's making

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a decision looking backwards, rather than to the future. Once you realize how much sway this bias has and the inherent danger of it, you're able to see more clearly and summon the logical thinking necessary to make decisions based on the future, rather than the past.

3. Show What Others Have Done

Have you ever been watching a performance when at its conclusion audience members give the performers a standing ovation? As more people around you join in do you feel the urge to also stand and clap? If you are like most people, you'll likely find yourself rising to your feet, in spite of the fact that you had not planned on doing so. Why? What force caused you to stand and why does it feel so odd to resist the urge?

The phenomenon that just occurred can best be explained by what behavioral economists refer to as social norms. These standards or expectations of behavior are highly influential. For example, when researchers partnered with a hotel and used social norms to increase the rate people reused their towels – they were able to increase reusage by 26 percent. Here's what they did. Patrons were informed that the majority of prior occupants of the room they were in had reused their towels. This created a social norm that it is normal for people who stay in this room to reuse towels and a result, most people did. This saved the hotel money and also helped the environment.

There are many ways that you can use social norms. When you show others how most people in their particular situation act, they will usually follow. This can be as simple as stating phrases such as, "Many people in your situation…" or "Our most popular option is..." Also, share surveys, stories and data that indicate what a lot of people are doing and you will find that others will perceive what you are recommending in a more favorable light.

4. Beware of The Overconfidence Effect

Believing in yourself and your company are hallmarks of successful entrepreneurs. However, is confidence ever a liability rather than an asset? Yes! When confidence evolves into an unhealthy, reckless overconfidence, it will frequently corrupt decision-making. In other words, confidence is good and a necessary characteristic of highly effective people, but overconfidence is dangerous because it will often inspire rushed, high-risk decisions that can cripple a business.

There is a wealth of research that shows the overconfidence effect is a rampant problem. Here are some examples of it:

- Despite the fact that according to Gallup, 50% of all startups fail within 5 years, one study found that new business owners vastly overestimate the probability that their businesses will prosper. The majority of entrepreneurs surveyed said there was a 70% chance or better of survival, with one-third of respondents stating they were 100% confident that their startup would defy the odds and succeed.

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- According to the US Census Bureau around half of all marriages end in divorce. Yet, when a researcher at Harvard Law School analyzed why so few people use prenuptial agreements, she identified that one of the primary reasons was because prior to marriage, most people believe that they will not get a divorce.

- Surveys indicate that only 2% of high school students believe they are below average, while 70% believe they have above average leadership abilities. However, most revealing of all, a whopping 25% state that they are in the top 1% in their ability to get along with others.

- Even the well-educated fall prey to the overconfidence effect, as a survey of college professors uncovered that 94 % believe that their work is above average.

So what's the harm in having unrealistic confidence levels? Overconfidence stifles creatively because it renders it unnecessary. In contrast, one research study found that posing questions to yourself that force you to come up with solutions, spurs innovation and boosts productivity. It's the difference between looking at a complex task and blindly declaring, "I will do this" versus asking "How will I do this?" The statement assumes everything will work out fine, while the question forces you to think of how you will create a solution. And that's often the difference between finding a solution quickly or not.

5. Never Label Something As "Free"

To gain new customers, startups regularly allow buyers to try their product or service for a short period of time, before they are asked to buy it. So how can you present this offer in a way that will nudge buyers to say "yes"? Don't tell them "it's free." There is compelling research that shows that when something is labeled "free" its value is diminished. Instead, state the monetary worth of what you are offering and then give it at no cost.

For instance, if you want prospective customers to try a subscription to your product inform them that you are so confident that they will love it that you will offer them "three months, which is valued at $120, at no cost." Here the perception of value is $120, whereas, if the request is framed as a "free three month subscription" then the value assigned is nothing. The more value you can infuse into your offer, the more likely your request will be met with acceptance.

By now I hope that you are convinced that insights from the flourishing field of behavioral economics can improve the effectiveness of any startup. I encourage you to review and apply the five principles I have shared because when you do it will provide the clarity and knowledge you need to better navigate the challenges of the marketplace.

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About the Author

David Hoffeld is the CEO and Chief Sales Trainer of Hoffeld Group and is the author of the groundbreaking book, "The Science of Selling." David has created a revolutionary sales approach based on neuroscience and behavioral science that radically increases sales. A sought-after sales thought leader and speaker David is a sales and leadership contributor to Fast Company and has been featured in Fortune, U.S. News and World Report, The Wall Street Journal, CBS Radio, Fox News Radio, and more. Learn more about David's innovative, science-based sales strategies at HoffeldGroup.com.

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